PEGASYSTEMS INC
Form 10-Q/A
May 08, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q/A

(Mark One)
[X] Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2001

or

[_] Transition Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: 1-11859

PEGASYSTEMS INC.
(Exact name of Registrant as specified in its charter)

Massachusetts (State or other jurisdiction of incorporation or organization)	04-2787865 (IRS Employer Identification No.)
101 Main Street Cambridge, MA (Address of principal executive offices)	02142-1590 (zip code)

(617) 374-9600
(Registrant's telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No____

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

There were 32,613,692 shares of the Registrant's common stock, $.01 par value per share, outstanding on May 1, 2001.

Explanatory Note

This form 10-Q/A has been filed because the original submission filed on May 7, 2001 was missing pages 4 and 12 of 17.

PEGASYSTEMS INC. AND SUBSIDIARIES
Index to Form 10-Q/A

PEGASYSTEMS INC.
Condensed Consolidated Balance Sheets
(in thousands, except share-related amounts)

	March 31, 2001
Assets	
Current assets:	
Cash and cash equivalents	$ 20,136

Trade and installment accounts receivable, net of allowance for doubtful accounts of $1,031 in 2001 and $1,037 in 2000	42,226
Prepaid expenses and other current assets	2,955
Total current assets	65,317
Long-term license installments, net	36,488
Equipment and improvements, net	5,816
Purchased software and other assets, net	4,770
Total assets	$112,391
Liabilities and Stockholders' Equity	
Current liabilities:	
Accounts payable and accrued expenses	$ 11,206
Deferred revenue	6,708
Current portion of capital lease obligations	289
Total current liabilities	18,203
Commitments and contingencies (Note E)	
Deferred income taxes	1,000
Capital lease obligations, net of current portion	27
Other long-term liabilities	43
Total liabilities	19,273
Stockholders' Equity:	
Preferred stock, $.01 par value, 1,000,000 shares authorized; no shares issued and outstanding	--
Common stock, $.01 par value, 45,000,000 shares authorized; 32,613,692 shares and 32,570,094 shares issued and outstanding in 2001 and 2000, respectively	326
Additional paid-in capital	100,939
Stock warrant	2,897
Deficit	(10,683)
Accumulated other comprehensive loss	(361)
Total stockholders' equity	93,118
Total liabilities and stockholders' equity	$112,391

See notes to condensed consolidated financial statements.

Page 4 of 17

PEGASYSTEMS INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	THREE MONTHS ENDED MARCH 31, 2001	2000

REVENUE:		
Software license	$10,882	$ 6,095
Services	11,935	11,911
Total revenue	22,817	18,006
COST OF REVENUE:		
Cost of software license	648	585
Cost of services	9,456	8,582
Total cost of revenue	10,104	9,167
GROSS PROFIT	12,713	8,839
OPERATING EXPENSES:		
Research and development	4,991	3,934
Selling and marketing	4,909	5,036
General and administrative	2,990	2,597
Total operating expenses	12,890	11,567
LOSS FROM OPERATIONS	(177)	(2,728)
Installment receivable interest income	1,450	943
Other interest income, net	214	403
Other (expense) income, net	(143)	28
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	1,344	(1,354)
Provision for income taxes	250	23
NET INCOME (LOSS)	$ 1,094	($1,377)
EARNINGS (LOSS) PER SHARE:		
Basic	$0.03	($0.05)
Diluted	$0.03	($0.05)
WEIGHTED AVERAGE NUMBER OF COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING:		
Basic	32,595	29,079
Diluted	33,462	29,079

See notes to condensed consolidated financial statements.

PEGASYSTEMS INC.
Condensed Consolidated Statements of Cash Flows
(in thousands)

	Three Mo Marc 2001
Cash Flows from Operating Activities:	
Net income (loss)	$ 1,094
Adjustments to reconcile net loss to net cash provided by operating activities:	
Depreciation and amortization	1,470
Provision for doubtful accounts	--
Changes in operating assets and liabilities:	
Trade and installment accounts receivable	93
Prepaid expenses and other current assets	(684)
Accounts payable and accrued expenses	(555)
Deferred revenue	1,643
Net cash provided by (used in) operating activities	3,061
Cash Flows from Investing Activities:	
Purchase of equipment and improvements	(188)
Other long term assets and liabilities	92
Net cash used in investing activities	(96)
Cash Flows from Financing Activities:	
Payments of capital lease obligation	(80)
Exercise of stock options	53
Sale of stock under Employee Stock Purchase Plan	--
Net cash provided by (used in) financing activities	(27)
Effect of exchange rate on cash and cash equivalents	(141)
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,797
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	$17,339
CASH AND CASH EQUIVALENTS, END OF PERIOD	$20,136

See notes to condensed consolidated financial statements.

PEGASYSTEMS INC.

Notes to Condensed Consolidated Financial Statements
March 31, 2001

Note A - Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of

Pegasystems Inc. (the "Company") presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2001 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2001. The Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2000, included in the Company's 2000 Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC").

Note B - Revenue Recognition

The Company's revenue is derived from two principal sources: software license fees and services fees. Software license fees are generally payable on a monthly basis under license agreements, which generally have a five-year term and may be renewed for additional years at the customer's option. The present value of future license payments is generally recognized as revenue upon customer acceptance. A portion of the fee from each arrangement is deferred and recognized as installment receivable interest income over the license term. In the case of software license agreement renewals, license fee revenue is recognized upon the commencement of the new license terms.

The Company's services revenue is comprised of fees for implementation, consulting, maintenance, and training services. Software license customers are offered the option to enter into an annual maintenance contract requiring the customer to pay a monthly maintenance fee renewable on a year-to-year basis. Prepaid maintenance fees are deferred based on their estimated fair value and are recognized ratably over the term of the maintenance agreement. The Company's software implementation agreements typically require the Company to provide a specified level of implementation services for a specified fee, typically with additional implementation services available at an hourly rate. Implementation fees for time and material projects are recognized as incurred. Implementation fees for fixed price projects are recognized once the fair value of services and any other elements to be delivered under the arrangement can be determined. Costs associated with fixed price contracts are expensed as incurred. Prior to the point at which the fair value of the elements of a contract can be determined, revenue recognition is limited to amounts equal to costs incurred during the reporting period, resulting in no gross profit. Once the fair values of the elements of a contract are apparent, profit associated with the services elements will begin to be recognized. Training and consulting fees are generally recognized as the services are provided.

Note C - Earnings (Loss) Per Share

(in thousands, except per share data)	Three Months Ended March 31, 2001	Three Months Ended March 31, 2000
Basic		
Net income (loss)	$ 1,094	($1,377)
Weighted average common shares outstanding	32,595	29,079

Basic earnings (loss) per share	$ 0.03	($0.05)
Diluted		
Net income (loss)	$ 1,094	($1,377)
Weighted average common shares outstanding	32,595	29,079
Effect of :		
Assumed exercise of stock options	867	--
Weighted average common shares outstanding, assuming dilution	33,462	29,079
Diluted earnings (loss) per share	$ 0.03	($0.05)

Basic earnings (loss) per share is computed based on the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share includes, to the extent inclusion of such shares would be dilutive to earnings per share, the effect of outstanding options and warrants, computed using the treasury stock method. For the three-months ended March 31, 2001 and 2000, 6,259,051 and 5,137,389 potential shares, respectively, have been excluded from the calculation, as such effect would be anti-dilutive.

Note D - Comprehensive Income

The components of the Company's comprehensive income are as follows:

(in thousands)	Three Months March 31 2001
Net income (loss)	$1,094
Foreign currency translation adjustments, net of income taxes	(92)
Comprehensive income (loss)	$1,002

Note E - Commitments and Contingencies

Company Litigation

Ernst & Young Case. On June 9, 2000, the Company, Alan Trefler, the Company's Chief Executive Officer, and Ira Vishner (a former chief financial officer of the Company) filed a complaint against Ernst & Young LLP ("Ernst & Young") and Alan B. Levine (a former partner of Ernst & Young) in Massachusetts state court ("the Complaint"). The Complaint alleged that the defendants committed professional malpractice, breached contractual and fiduciary duties owed to the Company, and issued false and misleading public statements, in connection with advice that Ernst & Young rendered to the Company to record $5 million in revenue in its financial statements for the second fiscal quarter ended June 30, 1997 pursuant to a series of contracts between the Company and First Data Resources, Inc. (the "FDR Contracts"). The Complaint sought compensatory damages, including contribution for losses and other costs incurred in connection with certain class action securities litigation, now settled, arising out of the Company's accounting for the FDR Contracts. On April 5, 2001, the court dismissed the Complaint, finding that it was subject to the dispute resolution procedures set forth in an engagement letter between the Company and Ernst & Young. Pursuant to those dispute resolution procedures, on April 19, 2001, the Company and Messrs. Trefler and Vishner, through counsel, notified Ernst & Young and Mr. Levine of their intention to submit the dispute that was the subject of the court action to mediation. If mediation is unsuccessful, the dispute resolution procedures provide that the dispute be submitted to arbitration.

SEC Investigation. In May 1999, the Boston office of the SEC issued a Formal Order of Private Investigation of the Company and unidentified individuals, currently or formerly associated with the Company, concerning past accounting matters, financial reports, and other public disclosures and trading activity in the Company's securities during 1997 and 1998. The Company continues to cooperate fully with the investigation.

Note F - Restructuring

During the three months ended December 31, 2000, the Company recorded a one-time restructuring charge of $1.0 million for the severance of 75 employees in various locations and certain costs associated with leased facilities. Approximately $0.2 million of additional depreciation expense was recorded due to reduced economic life of the leased facilities to be closed or idled under the restructuring plan. Restructuring activity associated with leased facilities is expected to be completed by the third quarter of 2001. As of December 31, 2000, $0.8 million of accrued severance remained unpaid. As of March 31, 2001, $0.1 million of accrued severance remained unpaid.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Historically, the timing of the Company's revenue has been unpredictable. The timing of license revenue recognition is related to the completion of implementation services and acceptance of the licensed software by the customer, the timing of which has proven difficult to predict accurately. The Company is more focused on closing larger but fewer license transactions than in the past. This may increase the volatility of the Company's quarterly operating results.

Three Months Ended March 31, 2001 Compared to Three Months Ended March 31, 2000

Total revenue for the three months ended March 31, 2001 ("first quarter of 2001") increased 27% to $22.8 million from $18.0 million in the three months ended March 31, 2000 ("first quarter of 2000"). The increase in total revenue was due to an increase in software license revenue.

Software license revenue for the first quarter of 2001 increased 79% to $10.9 million from $6.1 million in the first quarter of 2000. The increase was due primarily to software license lease renewals. An increase in perpetual license revenues to $1.5 million was offset by reduced revenues from new and add-on leases. Of the total increase in revenue, $0.6 million was due to improved accounting estimates relating to the revenue attributable to the inflation adjustment provisions contained in the Company's long-term software license agreements. These improved accounting estimates will continue to benefit the remaining quarters of 2001. A significant portion of the Company's software license revenue is from existing customers.

Services revenue from the first quarter of 2001 at $11.9 million was consistent with the first quarter of 2000.

Deferred revenue balances increased to $6.7 million as of March 31, 2001 from $5.1 million as of December 31, 2000, due primarily to annual maintenance billings in the first quarter of 2001 that are taken to revenue ratably during the year.

Cost of Revenue

Cost of software license revenue for the first quarter of 2001 increased 11% to $0.65 million from $0.59 million in the first quarter of 2000. Cost of software license includes the amortization associated with a stock purchase warrant issued by the Company in June 1997, and the Company's acquisition of software for resale. The increase was due to additional software acquired by the Company, which is being amortized over three years. Cost of software license as a percentage of license revenue decreased to 6% from 10% in the first quarter of 2000 due to the increase in license revenue.

Cost of services consists primarily of the costs of providing implementation, consulting, maintenance, and training services. Cost of services for the first quarter of 2001 increased 10% to $9.5 million from $8.6 million for the first quarter of 2000. Cost of services as a percentage of services revenue increased to 79% for the first quarter of 2001 from 72% for the first quarter of 2000. The increases were due to higher incentive compensation and benefits accruals and third party contracted consultants billed to customers, partially offset by the impact of the reduction in headcount implemented in the first quarter of 2001. Incentive compensation increased due to a combination of enhanced incentive opportunities and better performance versus goals.

Operating Expenses

Research and development expenses for the first quarter of 2001 increased 27% to $5.0 million from $3.9 million for the first quarter of 2000. The increase was due to higher incentive compensation and benefits accruals, contracted resources, and the redeployment of internal resources as part of the restructuring. As a percentage of total revenue, research and development expenses were 22% for the first quarter of 2001 and the first quarter of 2000.

Selling and marketing expenses for the first quarter of 2001 decreased to $4.9 million from $5.0 million for the first quarter of 2000. As a percentage of total revenue, selling and marketing expenses decreased to 22% for the first quarter of 2001 from 28% for the first quarter of 2000. The decreases were due to reduced discretionary spending such as travel and infrastructure costs, partially offset by higher incentive compensation accruals.

General and administrative expenses for the first quarter of 2001 increased 15% to $3.0 million from $2.6 million for the first quarter of 2000. The increase was due to higher incentive compensation and benefits accruals, corporate insurance costs, and miscellaneous tax accruals. As a percentage of total revenue, general and administrative expenses decreased to 13% for the first quarter of 2001 from 14% for the first quarter of 2000.

Installment Receivable Interest Income

Installment receivable interest income, which consists of the portion of all license fees under long-term software license lease agreements that is attributable to the time value of money, increased to $1.5 million in the first quarter of 2001 from $0.9 million in the first quarter of 2000. This increase was due to improved accounting estimates regarding the amount of interest income earned and higher average discount rates. A portion of the fee from each license lease arrangement is initially deferred and recognized as installment receivable interest income over the rest of the license term. For purposes of the present value calculations, the discount rate used has varied between 6.25% and 8.00% for the past few years.

Other Interest Income, net

Other interest income, net, decreased to $0.2 million in the first quarter of 2001 from $0.4 million in the first quarter of 2000, due to lower average balances of cash and cash equivalents.

Other Income (Expense), net

Other income (expense), net, which consists primarily of currency exchange gains or losses and reseller development funds received from third-party vendors of computer hardware products, was a $0.1 million loss for the first quarter of 2001, compared to a small gain in the first quarter of 2000. This decrease was due primarily to larger currency exchange losses, partially offset by increased reseller development funds received.

Provision for Income Taxes

The tax provision of $0.3 million for the first quarter of 2001 related to foreign subsidiary income tax, compared to a very small provision in the first quarter of 2000.

Liquidity and Capital Resources

Since its inception, the Company has funded its operations primarily through cash flow from operations, bank borrowings, and proceeds from the Company's public stock offerings. At March 31, 2001, the Company had cash and cash equivalents of $20.1 million and working capital of $47.1 million.

Net cash provided by operations for the first quarter of 2001 was $3.1 million compared with a small amount used in operations in the first quarter of 2000. The increase was due primarily to improved collections of annual billings, partially offset by increased operating expenses. Billings during the first quarter include annual license and maintenance amounts for some customers, typically resulting in more cash collections during the first quarter than in following quarters.

Net cash used in investing activities was $0.1 million for the first quarter of 2001, compared to $0.3 million in the first quarter of 2000. The change was due to a reduction in expenditures for equipment and improvements and a reduction in other long-term assets.

Financing activities used $27 thousand of cash during the first quarter of 2001, compared with providing $0.9 million during the first quarter of 2000. This change was mostly due to fewer exercises of stock options and a change made last year in the timing of the sale of stock under the Company's Employee Stock Purchase Plan ("ESPP"). The ESPP sales were during the first and fourth quarters of 2000, and will be during the second and fourth quarters of 2001.

The Company believes that current cash and cash equivalents will be sufficient to fund the Company's operations for the near term. There can be no assurance, however, that changes in the Company's plans or other events affecting the Company's operations will not result in materially accelerated or unexpected expenditures. In addition, there can be no assurance that additional capital, if needed, will be available on reasonable terms, if at all, at such time as required by the Company.

Inflation

Inflation has not had a significant impact on the Company's operating results to date, and the Company does not expect it to have a significant impact in the future. The Company's license and maintenance fees are typically subject to annual increases based on recognized inflation indexes.

Forward-Looking Statements

Certain statements contained in this Form 10-Q/A may be construed as "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. These statements involve various risks and uncertainties which could cause the Company's actual results to differ from those expressed in such forward-looking statements. These risks and uncertainties include the effect of losses from prior periods, liquidity issues, regulatory proceedings, seasonal variation of the Company's operations and fluctuations in the Company's quarterly results, rapid technological change involving the Company's products and those of competitors, delays in product development and implementation, the technological compatibility of the Company's products with its customers' systems, the Company's dependence on customers in the financial services market, intense competition in the markets for the Company's products, risk of non-renewal by current customers, and other risks and uncertainties. Further information regarding those factors which could cause the Company's actual results to differ materially from any forward-looking statements contained herein is provided below.

The Company is being investigated by the Securities and Exchange Commission. In May of 1999, the Boston office of the SEC issued a Formal Order of Private Investigation of the Company and certain individuals, currently or formerly associated with the Company, concerning past accounting matters, financial reports and other public disclosures and trading activity in the Company's securities during 1997 and 1998. Such investigation may result in the SEC imposing fines on the Company or taking other measures that may have a material adverse impact on the Company's financial position or results of operations. In addition, regardless of the outcome of the investigation, it is likely that the Company will incur substantial defense costs and that such investigation will cause a diversion of management time and attention. Finally, the negative publicity resulting from the investigation has made and may continue to make it more difficult for the Company to close sales, which in turn could have a material adverse impact on the Company's financial position or results of operations.

The Company had material weaknesses in its internal control environment. The Company's independent public accountants identified material weaknesses in the Company's internal control environment in connection with their audits of the Company's 1997, 1998 and 1999 financial statements. This has had and may continue to have a material adverse impact on the Company's reputation, which in turn could have a material adverse impact on the Company's financial position or results of operations. The Company has added resources to its finance function and is working diligently with the suggestions of the auditors to improve internal control. In connection with the audit of the Company's 2000 financial statements the independent auditors have indicated that they will not issue a material weakness letter.

Mr. O'Halloran, the Company's Chief Financial Officer, has indicated his intention to retire during the second quarter of 2001.

The Company's stock price has been volatile. Quarterly results have fluctuated and are likely to continue to fluctuate significantly. The market price of the Company's common stock has been and may continue to be highly volatile. Factors that are difficult to predict, such as quarterly revenues and operating results, statements and ratings by financial analysts, overall market performance and the outcome of litigation, will have a significant effect on the price for shares of the Company's common stock. Revenues and operating results have varied considerably in the past from period to period and are likely to vary considerably in the future. The Company plans product development and other expenses based on anticipated future revenue. If revenue falls below expectations, financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of operating results are not necessarily meaningful and should not be relied upon to predict future performance.

The timing of license revenues is related to the completion of implementation services and product acceptance by the customer, the timing of which has been difficult to predict accurately. There can be no

assurance that the Company will be profitable on an annual or quarterly basis or that earnings or revenues will meet analysts' expectations. Fluctuations may be particularly pronounced because a significant portion of revenues in any quarter is attributable to product acceptance or license renewal by a relatively small number of customers. Fluctuations also reflect a policy of recognizing revenue upon product acceptance or license renewal in an amount equal to the present value of the total committed payments due during the term. Customers generally do not accept products until the end of a lengthy sales cycle and an implementation period, typically ranging from one to six months but in some cases significantly longer. In addition, the Company is more focused on closing larger but fewer license transactions than in the past. This may increase the volatility in the Company's quarterly operating results. Risks over which the Company has little or no control, including customers' budgets, staffing allocation, and internal authorization reviews, can significantly affect the sales and acceptance cycles. Changes dictated by customers may delay product implementation and revenue recognition.

THE COMPANY WILL NEED TO DEVELOP NEW PRODUCTS, EVOLVE EXISTING ONES, AND ADAPT TO TECHNOLOGY CHANGE. Technical developments, customer requirements, programming languages and industry standards change frequently in the Company's markets. As a result, success in current markets and new markets will depend upon the Company's ability to enhance current products, to develop and introduce new products that meet customer needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement and testing. There can be no assurance that the Company will have sufficient resources to make necessary product development investments. Pegasystems may experience difficulties that will delay or prevent the successful development, introduction or implementation of new or enhanced products. Inability to introduce or implement new or enhanced products in a timely manner would adversely affect future financial performance. The Company's products are complex and may contain errors. Errors in products will require the Company to ship corrected products to customers. Errors in products could cause the loss of or delay in market acceptance or sales and revenue, the diversion of development resources, injury to the Company's reputation, or increased service and warranty costs which would have an adverse effect on financial performance.

THE COMPANY HAS HISTORICALLY SOLD TO THE FINANCIAL SERVICES MARKET. This market is consolidating rapidly, and faces uncertainty due to many other factors. The Company has historically derived a significant portion of its revenue from customers in the financial services market, and its future growth depends, in part, upon increased sales to this market. Competitive pressures, industry consolidation, decreasing operating margins within this industry, currency fluctuations, geographic expansion and deregulation affect the financial condition of the Company's customers and their willingness to pay. In addition, customers' purchasing patterns are somewhat discretionary. As a result, some or all of the factors listed above may adversely affect the demand by customers. The financial services market is undergoing intense domestic and international consolidation. In recent years, several customers have been merged or consolidated. Future mergers or consolidations may cause a decline in revenues and adversely affect the Company's future financial performance.

IF EXISTING CUSTOMERS DO NOT RENEW THEIR LICENSES, THE COMPANY'S FINANCIAL RESULTS MAY SUFFER. A significant portion of total revenue has been attributable to license renewals. While historically a substantial majority of customers have renewed their licenses, there can be no assurance that a substantial majority of customers will continue to renew expiring licenses. A decrease in license renewals absent offsetting revenue from other sources would have a material adverse effect on future financial performance. In addition, possible transition to a perpetual or prepaid extended term license may have a material adverse impact on the amount of license renewal revenues in future periods.

THE COMPANY DEPENDS ON CERTAIN KEY PERSONNEL, AND MUST BE ABLE TO ATTRACT AND RETAIN QUALIFIED PERSONNEL IN THE FUTURE. The business is dependent on a number of key, highly skilled technical, managerial, consulting, sales, and marketing personnel, including Mr. Trefler, the Company's Chief Executive Officer. The loss of key personnel could adversely affect financial performance. The Company does not have any key-man

life insurance on any officers or employees and does not plan to put any in place. The Company's success will depend in large part on its ability to hire and retain qualified personnel. The number of potential employees who have the extensive knowledge of computer hardware and operating systems needed to develop, sell and maintain its products is limited, and competition for their services is intense, and there can be no assurance that the Company will be able to attract and retain such personnel. If the Company is unable to do so, the Company's business, operating results, and financial condition could be materially adversely affected.

The market for the Company's offerings is increasingly and intensely competitive, rapidly changing, and highly fragmented. The market for customer relationship management software and related implementation, consulting and training services is intensely competitive and highly fragmented. The Company currently encounters significant competition from internal information systems departments of potential or existing customers that develop custom software. It also competes with companies that target the customer interaction and workflow markets and professional services organizations that develop custom software in conjunction with rendering consulting services. Competition for market share and pressure to reduce prices and make sales concessions are likely to increase.

Many competitors have far greater resources and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards or to changes in customer requirements or preferences. Competitors may also be able to devote greater managerial and financial resources to develop, promote and distribute products and provide related consulting and training services. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not materially adversely affect its business, operating results, and financial condition.

The Company relies on certain third-party relationships. The Company has a number of relationships with third parties that are significant to sales, marketing and support activities and product development efforts. The Company relies on relational database management system applications and development tool vendors, software and hardware vendors, and consultants to provide marketing and sales opportunities for the direct sales force and to strengthen the Company's products through the use of industry-standard tools and utilities. The Company also has relationships with third parties that distribute its products. In particular, the Company relies on its relationship with First Data Corporation for the distribution of products to the credit card market, with PFPC Inc. for distribution of products to the mutual fund market and on Carreker Inc. for the distribution of its products to the banking industry. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources, will not develop or market products that compete with those of the Company in the future or will not otherwise end their relationships with or support of the Company.

The Company may face product liability and warranty claims. The Company's license agreements typically contain provisions intended to limit the nature and extent of the Company's risk of product liability and warranty claims. There is a risk that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Also, there is a risk that these contract terms might not bind a party other than the direct customer. Furthermore, some of the Company's licenses with its customers are governed by non-U.S. law, and there is a risk that foreign law might give the Company less or different protection. Although the Company has not experienced any material product liability claims to date, a product liability suit or action claiming a breach of warranty, whether or not meritorious, could result in substantial costs and a diversion of management's attention and the Company's resources.

The Euro's adoption imposes product and market risks. A new currency, the "Euro", was introduced in certain Economic and Monetary Union ("EMU") countries in early 1999. It is expected that by 2002, all participating EMU countries will use the Euro as their single currency. As a result, software used by many companies headquartered or maintaining a subsidiary in a participating EMU country is expected to be Euro-enabled. All companies headquartered or maintaining a subsidiary in an EMU country will need to be Euro-enabled. These changes will change budgetary, accounting and fiscal systems in companies and public administration, and require the simultaneous handling of parallel currencies and conversion of legacy data.

These requirements may curb market demand for the Company's products because the budgets and priorities of its customers and prospective customers may change. The Company is monitoring the rules and regulations as they become known in order to make any changes to its software products that the Company deems necessary to comply with such rules and regulations. Although the Company believes that its most recent products address these requirements, there can be no assurance that the rules and regulations will not change and that the

Company's software will contain all of the necessary changes or meet all Euro requirements. Any inability to comply with the Euro requirements could have an adverse effect on the Company's business, operating results and financial condition.

The Company faces risks from operations and customers based outside of the U.S. Sales to customers headquartered outside of the United States represented approximately 26%, 21% and 23% of the Company's total revenue in 2000, 1999 and 1998, respectively. The Company, in part through its wholly owned subsidiaries based in the United Kingdom, Singapore, and Australia, markets products and renders consulting and training services to customers based in Canada, the United Kingdom, France, Germany, the Netherlands, Switzerland, Ireland, Mexico, Sweden, Australia, Austria, Hong Kong, and Singapore. The Company has established offices in continental Europe and in Australia. The Company believes that its continued growth will necessitate expanded international operations requiring a diversion of managerial attention and financial resources. The Company anticipates hiring additional personnel to accommodate international growth, and the Company may also enter into agreements with local distributors, representatives, or resellers. If the Company is unable to do one or more of these things in a timely manner, the Company's growth, if any, in its foreign operations will be restricted, and the Company's business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that the Company will be able to maintain or increase international market demand for its products. Most of the Company's international sales are denominated in U.S. dollars. Accordingly, any appreciation of the value of the U.S. dollar relative to the currencies of those countries in which the Company distributes its products may place the Company at a competitive disadvantage by effectively making its products more expensive as compared to those of its competitors. Additional risks inherent in the Company's international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing products for local markets and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of "double taxation"), enhanced accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws. There can be no assurance that one or more of these factors will not have a material adverse effect on the Company's foreign operations, and, consequentially, the Company's business, operating results, and financial condition.

The Company faces risks related to intellectual property claims or appropriation of its intellectual property rights. The Company relies primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect its proprietary rights. In October 1998, the Company was granted a patent by the United States Patent and Trademark Office relating to the architecture of the Company's systems. There can be no assurance that such patent will not be invalidated or circumvented or that rights granted thereunder or the description contained therein will provide competitive advantages to the Company's competitors or others. Moreover, despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company's products or to obtain the use of information that the Company regards as proprietary. In addition, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States. There can be no assurance that the Company's means of protecting its proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology.

The Company is not aware that any of its products infringe the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. The Company expects that software product developers will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays, or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results, and financial condition.

PEGASYSTEMS INC.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Reference is made to Part II, Item 7A, "Quantitative and Qualitative Disclosures about Market Risk," in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

Part II - Other Information:

Item 1. Legal Proceedings

Ernst & Young Case. On June 9, 2000, the Company, Alan Trefler, the Company's Chief Executive Officer, and Ira Vishner (a former chief financial officer of the Company) filed a complaint against Ernst & Young LLP ("Ernst & Young") and Alan B. Levine (a former partner of Ernst & Young) in Massachusetts state court ("the Complaint"). The Complaint alleged that the defendants committed professional malpractice, breached contractual and fiduciary duties owed to the Company, and issued false and misleading public statements, in connection with advice that Ernst & Young rendered to the Company to record $5 million in revenue in its financial statements for the second fiscal quarter ended June 30, 1997 pursuant to a series of contracts between the Company and First Data Resources, Inc. (the "FDR Contracts"). The Complaint sought compensatory damages, including contribution for losses and other costs incurred in connection with certain class action securities litigation, now settled, arising out of the Company's accounting for the FDR Contracts. On April 5, 2001, the court dismissed the Complaint, finding that it was subject to the dispute resolution procedures set forth in an engagement letter between the Company and Ernst & Young. Pursuant to those dispute resolution procedures, on April 19, 2001, the Company and Messrs. Trefler and Vishner, through counsel, notified Ernst & Young and Mr. Levine of their intention to submit the dispute that was the subject of the court action to mediation. If mediation is unsuccessful, the dispute resolution procedures provide that the dispute be submitted to arbitration.

SEC Investigation. In May 1999, the Boston office of the SEC issued a Formal Order of Private Investigation of the Company and unidentified individuals, currently or formerly associated with the Company, concerning past accounting matters, financial reports, and other public disclosures and trading activity in the Company's securities during 1997 and 1998. The Company continues to cooperate fully with the investigation.

Item 2. Changes in Securities and Use of Proceeds
None.

Item 3. Defaults upon Senior Securities
Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders
None

Item 5. Other Information
None

Item 6. Exhibits and Reports on Form 8-K
None

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Pegasystems Inc.

Date: May 4, 2001

/s/ Alan Trefler

Chairman and Chief Executive Officer

/s/ James P. O'Halloran

James P. O'Halloran
Treasurer and Chief Financial Officer
(principal financial officer and chief accounting officer)